September 8, 2011

CC: PA: LPD: PR (REG-101826-11)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

To Whom It May Concern:

The Community Development Venture Capital Alliance (“CDVCA”) submits this letter of comment in response to notice of proposed rulemaking REG-101826-11, dated June 7, 2011. CDVCA submitted broader comments about regulatory changes that would be necessary to encourage venture capital equity investment in entrepreneurial operating businesses in our letter dated September 6, 2011 in response to advance notice of proposed rulemaking REG-114206-11. While some of the information in that submission is repeated here, please refer to the September 6 letter for a fuller discussion of how to make the New Markets Tax Credit more workable for venture capital equity investors. This letter focuses on ways to make the specific amendments to regulations proposed in REG-101826-11 applicable to venture capital equity investment.

CDVCA is the trade association of community development venture capital (“CDVC”) funds. We represent 73 domestic CDVC funds with aggregate capital under management of more than $2 billion. Our member funds provide venture capital financing, mostly in the form of equity and near-equity financial instruments, to rapidly growing operating businesses that create good, permanent jobs for low income people primarily in low income areas. CDVCA is both a CDE and a CDFI, as are many of our members and their affiliates.

We strongly commend the Department of the Treasury, the Internal Revenue Service, and the CDFI Fund for your interest in finding ways to facilitate use of the New Market Tax Credit (“NMTC”) to encourage financing for operating businesses. In particular, it is important that patient, flexible equity and near-equity financing be made available to rapidly-growing, entrepreneurial businesses,
which create most of the net new jobs in our economy, in low- and high-income areas alike. This type of entrepreneurial, high impact business, which the Obama administration has expressed a particular interest in encouraging, is the natural market focus of CDVC funds. While the NMTC was originally intended to encourage patient, flexible equity capital investment for such businesses, the mechanics of how the credit was implemented have unintentionally made it virtually impossible to use it for this purpose. The regulatory changes recommended below would allow the NMTC to be used more effectively for its originally intended purpose of encouraging greater job creation and community revitalization.

A. Rapidly-growing, entrepreneurial small businesses, of the type that CDVC funds finance, are crucial to the creation of new, permanent jobs in our economy

The consensus of peer-reviewed studies of job creation is that small businesses are responsible for the lion’s share of net new jobs in our economy. However, the major job creators are not just average small businesses. Recent studies from the National Bureau of Economic Research, the Kauffman Foundation, and the U.S. Small Business Administration all show that almost all net new job creation in our economy comes from a small group of rapidly growing small businesses, commonly called “Gazelles” or “High-Impact Firms.”¹ For example, the SBA study found that these High-Impact Firms “represent between 2 and 3 percent of all firms, and they account for almost all of the private sector job growth in the economy.”² Furthermore, the study found that High-Impact Firms are not limited to the archetypal Silicon Valley start-up, but rather have an average age of 25 years, are distributed geographically throughout the country, and exist in all industries. The study concludes that “economic development officials would benefit from recognizing the value of cultivating high-growth firms versus trying to increase entrepreneurship overall or trying to attract relocating companies when utilizing their resources.”³ Likewise, the Department of the Treasury must make an extra effort to make the NMTC program serve this type of job-creating business effectively if it wants the program to have the maximum possible impact on job creation in the nation.

Unlike most jobs created by the real estate and project finance investments that currently dominate the NMTC program, the jobs created by High Impact Firms are permanent jobs that provide employment to low income populations year after year. Furthermore, the type of indigenous job creation encouraged by community development venture capital financing is dependent on home-grown

---


² See Small Business Administration, Footnote 2, at p. 2.

³ Id. at p.44.
entrepreneurs who have deep roots in their communities. They do not leave these communities to seek tax breaks or other transient incentives elsewhere. The jobs they create are permanent drivers of their local economies.

While entrepreneurial High Impact Firms are vital to job creation and our economy, they typically cannot finance their growth with debt, because they consume cash as they grow rapidly. Furthermore, these companies rarely have sufficient collateral or profitability to attract debt capital from a traditional bank, let alone from the risk-averse leverage lenders common in most NMTC deal structures.

Venture capital fills the financing gap faced by High Impact Firms by providing patient, flexible equity capital. Community development venture capital (CDVC) funds like CDVCA and its members provide this type of financing for high-growth operating businesses in underinvested, low-income markets. CDVC fund investments create entrepreneurial capacity and good, permanent employment opportunities accessible to low-income people.

Despite the importance of equity capital in creating and maintaining jobs in low income communities, equity capital is in short supply for businesses in these communities. Unlike debt, venture capital equity financing is concentrated in just a few areas of the nation. In fact, two thirds of all mainstream venture capital investments are made in just five areas of the nation (the San Francisco Bay Area, Boston, New York, Houston, and Los Angeles), and only a miniscule percentage of venture capital is invested in low income communities. As for rural areas, a CDVCA study featured in the Wall Street Journal found that less than 1% of traditional venture capital investment went to rural areas, while 19% of our CDVC member investments went to these areas. CDVC funds target businesses that provide good employment opportunities to low-income persons, as compared with the high-tech businesses that most venture capital funds target, which often provide employment primarily to highly skilled employees with exceptional educational backgrounds. The incentive provided by the NMTC is needed to drive additional capital into these businesses in low income communities.

The economic downturn has made it more difficult for all venture capital funds to raise money and exacerbated the inequities inherent in the distribution of mainstream venture capital. Although all venture capital investment is risky, CDVCA has found that the perceived risk of investing in low income community businesses has made it extremely difficult to raise capital explicitly intended for these communities. This perceived risk makes government and nonprofit assistance all the more necessary if High Impact Firms are to succeed in low income communities.

---

B. The re-investment requirement makes venture capital equity investment in entrepreneurial, rapidly growing businesses virtually impossible

When it created the NMTC program, Congress correctly recognized that businesses in low-income communities require patient, long-term equity capital. However, the translation of “patient and long-term” into “exactly 7 years” has unintentionally made it difficult to use the credit for venture capital equity financing. A loan can be structured to have a term of exactly 7 years. However, the investor in an equity or near equity investment of the type commonly used by venture capitalists is repaid only when an event occurs (a “liquidity event”) that makes cash available to repay an investor (the investment “exit”). This liquidity event might result from an initial public offering of stock, a sale of the company, a recapitalization, a management buy-back, creation of an Employee Stock Ownership Plan, or a variety of other occurrences. While the venture capitalist works diligently with its portfolio companies to bring about such events and achieve liquidity, the venture capitalist is not in control of the timing of an exit.

From a public policy perspective, while equity investments might not have a term of exactly 7 years, they are the epitome of patient capital: they are required to be repaid only when an event occurs that provides the company with cash to make the repayment. Until that time, the company has the use of cash that is subordinated to all debt in its capital structure, and can use the funds to grow and leverage other sources of financing.

The problem with respect to the tax credit is that a liquidity event might occur after 7 years, but it might also occur after 10 years or after 4 years, and the venture capital investor cannot determine the timing of its “exit.” Because of the draconian recapture rules of the NMTC, tax credit investors are unlikely to invest when there is any significant possibility of an early repayment of tax credit capital. In addition, venture capital funds often do not have a sufficient pipeline of investments to guarantee reinvestment within the one-year reinvestment period, even if investors were willing to take this reinvestment risk. The 7-year investment requirement, as it is implemented under current regulations, makes it virtually impossible to find investors for true venture capital financing.

C. Response to Proposed Amendments to Regulations

The proposed changes to the regulations seem to be aimed primarily at lenders providing amortizing debt to operating businesses. The gradual step-down in the re-investment requirement would accommodate the amortization of principal. While CDVCA believes that the ability to provide amortizing debt to operating businesses in low-income communities is important, our members generally do not use such debt instruments, so we will not comment directly on the exact text of the proposed amendments. However, we believe that an analogous mechanism could be extremely useful in addressing the re-investment risk issue discussed above with respect to venture capital equity investments. We will therefore propose some additional changes to the regulations that would make them work for equity investments of the type the venture capitalists generally make.
1. Why the amendments proposed in REG-101826-11 would not facilitate venture capital equity investment.

As we explain above, the reason the current reinvestment requirement makes venture capital equity investment in operating businesses unworkable is the possibility of an early investment exit created by a liquidity event that occurs in less than 7 years. If and when such an exit occurs, 100% of capital (plus additional earnings, if any) is generally returned to the investor at once. There is no gradual, controlled schedule of principal repayment, as there is with self-amortizing debt. It is often difficult or impossible to postpone this payment. For example, when a company is sold to another company (the most common type of liquidity event) the purchaser typically wants to acquire the entire company immediately and would not tolerate a continuing obligation to an NMTC investor. (This is not conjecture; one of our members has tried to create such a structure and found that companies will not accept it because of the possibility that the structure would interfere with attracting buyers.)

2. Regulatory changes necessary to alleviate the re-investment risk problem for venture capital equity investment in operating businesses.

While the regulatory amendments as currently set forth in REG-101826-11 do not address the re-investment risk problem as it exists for venture capital equity investing, we believe that the approach taken there, with some changes, would solve the problem to a meaningful extent. We have attached in an addendum to this letter some suggested changes and additions to the amendments proposed in REG-101826-11. Essentially, they borrow the CDFI reinvestment approach but eliminate the gradual step-down of the initial proposal and allow full investment of returned capital in a qualifying CDFI in cases where a non-real estate qualified low-income community investment is used to make equity capital investments (defined as suggested below) in non-real estate businesses. This change is necessary to accommodate the fact that, when venture capital exits occur, generally 100% of capital is returned immediately.

3. Definition of equity capital qualified low income community investment.

To differentiate equity investments from other uses of NMTC capital, as is necessary for the proposals made in this letter, equity investment must be defined. We recommend using the same definition that the Small Business Administration developed for the New Markets Venture Capital ("NMVC") program. Congress created the NMVC program in 2000 at the same time that it created the

---

5 We believe that a number of additional regulatory changes must be made to fully facilitate venture capital equity investment in operating businesses. These are set forth in our comment letter dated September 6, 2011 in response to advance notice of proposed rulemaking REG-114206-11. We also believe that the two-CDE model suggested in that letter deals effectively with the re-investment problem and may be superior to the CDFI approach set forth here. Allowing CDEs the flexibility of taking either approach would be ideal.
The two programs were intended to serve similar purposes and to work together, although, for technical reasons, this never occurred. Six NMVC Companies were initially created and still operate under the program, and this definition has served well in practice to delineate their real-world investment practices. In the NMVC legislation, Congress required that, unlike Small Business Investment Companies (“SBICs”) which typically provide debt and mezzanine loans (although they are permitted to make equity investments as well), NMVC companies should be limited to making “equity capital investments.” The issue that the SBA faced in defining equity investing was analogous to the one the Department of the Treasury would face if it chooses to distinguish equity investments from loans. The definition of “Equity Capital Investments” developed by the SBA for this purpose and implemented under the regulations of the NMVC program is as follows:

**Equity Capital Investments** means investments in the form of common or preferred stock, limited partnership interests, options, warrants, or similar equity instruments, including subordinated debt with equity features if such debt provides only for interest payments contingent upon and limited to the extent of earnings. Equity Capital Investments must not require amortization. Equity Capital Investments may be guaranteed by one or more third parties; however, neither Equity Capital Investments nor such guarantee may be collateralized or otherwise secured. Investments classified as Debt Securities are not precluded from qualifying as Equity Capital Investments. Equity Capital Investments may provide for royalty payments only if the royalty payments are based on the earnings of the concern. 13 CFR Ch. I Section 108.50

4. **Why this arrangement will not be abused**

An obvious concern with creating such a broad exception to the reinvestment requirement is that it might be abused by somehow creating a series of investments that would be exited within a short period of time, while the NTMC investor would receive the credit for a full 7 years. We believe this is unlikely and can be protected against. First of all, if an investment is truly an equity investment of the type that venture capitalists make, the venture capitalist cannot control the time of exit, as explained above. Without control of the timing of an exit, such abuse cannot occur. Second, the CDE, not the investor, is in control of the investment structure. While the investor might have incentive to encourage an early exit, the CDE does not. In particular, if the CDE has an economic stake in the success the investment (and therefore of the business), as suggested in our September 6 comment letter, then the CDE will have no interest in making short-term investments because it would have less opportunity to make investment returns. In addition, the annual management fee that CDEs collect for managing investments would probably be ended or curtailed by investors if funds are no longer

---

6 The two programs were both enacted in December 2000 as part of the Consolidated Appropriations Act of 2001. The bills that created the two programs were both first introduced in the House on December 14, 2000, the NMTC program in H.R. 5662 and the NMVC program in H.R 5663.
invested in a QALICB. Finally, the CDFI Fund should require reporting of early exits; if a
CDE were to make a series of equity investments that exited substantially prior to the 7-year
credit period, that CDE should be disfavored from receiving future allocations.

5. **CDEs should have 1-year, not 30 days, to decide whether to reinvest returned capital or
   invest it in a CDFI**

   It is not clear to us what the public policy purpose is of requiring a CDE to decide within
30 days whether to reinvest capital in a QALICB or in a CDFI. It would seem preferable to
allow a CDE a full year to try to find a qualifying investment before settling on reinvestment in
a CDFI.

In closing we would like to point out that, even with the regulatory changes
recommended in this letter, using tax credit capital to make equity investments in
entrepreneurial operating businesses of the type that a venture capital fund would typically
make will still be very challenging. Most CDEs and investors will continue to prefer the easy
route of making low-risk investments for real estate development and project finance. If the
Department of the Treasury becomes too concerned with closing every avenue of potential
abuse, it risks making true equity investment using the credit too difficult. Rather, the Treasury
should consider adopting not only the recommendations contained in this letter and the attached
addendum, but also those we made in our letter dated September 6, 2011 in response to the
advance notice of proposed rulemaking REG-114206-11. The Treasury should think of ways,
including awarding extra points to applicants planning to use their NMTC allocation to make
equity investments in operating businesses, to encourage this type of investment activity, which
is so crucial to effective job creation and to our nation’s economic recovery.

Thank you for the opportunity to submit comments on this important subject.

Sincerely yours,

Kerwin Tesdell
ADDENDUM – SUGGESTED MODIFICATION TO PROPOSED RULES CHANGE

[Changes are set in large bold font]

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows: Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.45D-1 is amended by:

1. Amending paragraph (a) as follows:
   b. Revising the entry for paragraph (d)(1)(i).

2. Revising paragraphs (c)(1)(iii), (c)(3)(ii), and (d)(1)(i).

3. Adding new paragraphs (c)(8), (d)(9), (d)(10) and (h)(3).

The additions and revisions read as follows:

§1.45D-1 New Markets tax credit.

* * * * *
(c) * * *
(8) Non-real estate qualified equity investment.
(d) * * *
(1) * * *
(i) Investment in a qualified active low-income community business or a non-real estate qualified active low-income community business.
* * * * *
(9) Non-real estate qualified active low-income community business.
   (i) Definition.
   (ii) Payments of, or for, capital, equity or principal with respect to a non-real estate qualified active low-income community business.
   (A) In general.
   (B) Seventh year of the credit period.
   (C) Amounts received from a certified Community Development Financial Institution.

(10) Equity capital qualified low-income community investment.

* * * * *
(h) * * *
(3) Investments in non-real estate businesses.

* * * * *

(c) * * *
(1) * * *
(iii) The investment is designated for purposes of section 45D and this section as a qualified equity investment or a non-real estate qualified equity investment (as defined in paragraph (c)(8) of this section) by the CDE on its books and records using any reasonable method.

(3) * * *

(ii) * * * Notwithstanding paragraph (c)(3)(i) of this section, an equity investment in an entity is eligible to be designated as a qualified equity investment or a non-real estate qualified equity investment under paragraph (c)(1)(iii) of this section if--

(8) Non-real estate qualified equity investment. If a qualified equity investment is designated as a non-real estate qualified equity investment under paragraph (c)(1)(iii) of this section, then the qualified equity investment may only satisfy the substantially-all requirement under paragraph (c)(5) of this section if the CDE only makes qualified low income community investments that are directly traceable to non-real estate qualified active low-income community businesses (as defined in paragraph (d)(9) of this section). The proceeds of a non-real estate qualified equity investment cannot be used for transactions involving a qualified active low-income community business that is not a non-real estate qualified active low-income community business.

(d) * * *

(1) * * *

(i) Investment in a qualified active low-income community business or a non-real estate qualified active low-income community business. Any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in paragraph (d)(4) of this section) or any non-real estate qualified active low income community business (as defined in paragraph (d)(9) of this section).

(9) Non-real estate qualified active low-income community business—

(i) Definition. The term non-real estate qualified active low-income community business means any qualified active low-income community business (as defined in paragraph (d)(4) of this section) whose predominant business activity does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate. For purposes of the preceding sentence, predominant business activity means a business activity that generates more than 50 percent of the business’ gross income. The purpose of the capital or equity investment in, or loan to, the non-real estate qualified active low income community business must not be connected to the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate.

(ii) Payments of, or for, capital, equity or principal with respect to a non-real estate qualified active low-income community business—
(A) In general. For purposes of paragraph (d)(2)(i) of this section, a portion of the amounts received by a CDE in payment of, or for, capital, equity, or principal with respect to a non-real estate qualified active low-income community business after year one of the 7-year credit period (as defined by paragraph (c)(5)(i) of this section) may be reinvested by the CDE in a certified community development financial institution that is a CDE under section 45D(c)(2)(B) (certified CDFI) (as defined by 12 CFR Part 1805.201) and that is unrelated to the CDE (in accordance with section 267(b) or section 707(b)(1)). Any portion that the CDE chooses to reinvest in a certified CDFI must be reinvested by the CDE no later than 30-days one year from the date of receipt to be treated as continuously invested in a qualified low-income community investment for purposes of paragraph (d)(2)(i) of this section. If the amount reinvested in a certified CDFI exceeds the maximum aggregate portion of the non-real estate qualified equity investment, then the excess will not be treated as invested in a qualified low-income community investment. The maximum aggregate portion of the non-real estate qualified equity investment that may be reinvested into a certified CDFI, which will be treated as continuously invested in a qualified low-income community investment, may not exceed the following percentages of the non-real estate qualified equity investment in the following years:

(1) For non-real estate qualified equity investments used to make qualified low income community investments in non-real estate qualified active low income community businesses:
   (a) 15 percent in Year 2 of the 7-year credit period;
   (b) 30 percent in Year 3 of the 7-year credit period;
   (c) 50 percent in Year 4 of the 7-year credit period; and
   (d) 85 percent in Year 5 and Year 6 of the 7-year credit period.

(2) For non-real estate qualified equity investments used to make equity capital qualified low-income community investments in non-real estate qualified active low income community businesses, as the term equity capital qualified low income community investment is defined in paragraph (d)(10):
   (a) 100% in Years 2 through 6 of the 7-year credit period.

(B) Seventh year of the credit period. Amounts received by a CDE in payment of, or for, capital, equity, or principal with respect to a non-real estate qualified active low-income community business (as defined in paragraph (d)(9)(i) of this section) during the seventh year of the 7-year credit period do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

(C) Amounts received from a certified Community Development Financial Institution. Except for the seventh year of the credit period under paragraph
(d)(9)(ii)(B) of this section, amounts received from a certified CDFI must be reinvested by the CDE no later than 30 days from the date of receipt to be treated as continuously invested in a qualified low-income community investment.

(10) **Equity capital qualified low-income community investment.** For purposes of this section, the term **equity capital qualified low income community investments** means any **qualified low-income community investment**, as defined in paragraph (d)(1), which is also an **equity capital investment** as defined by 13 CFR Ch. 1 Section 108.50¹.

(h) * * *

(3) **Investments in non-real estate businesses.** The rules in paragraphs (c)(8) and (d)(9) of this section apply to taxable years ending on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

---

¹ 13 CFR Ch. 1 Section 108.50: *Equity Capital Investments* means investments in the form of common or preferred stock, limited partnership interests, options, warrants, or similar equity instruments, including subordinated debt with equity features if such debt provides only for interest payments contingent upon and limited to the extent of earnings. Equity Capital Investments must not require amortization. Equity Capital Investments may be guaranteed by one or more third parties; however, neither Equity Capital Investments nor such guarantee may be collateralized or otherwise secured. Investments classified as Debt Securities are not precluded from qualifying as Equity Capital Investments. Equity Capital Investments may provide for royalty payments only if the royalty payments are based on the earnings of the concern.